

Roundup

An Update on Government Contracts Issues for Clients & Friends

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Excessive Pass-Through or Excessive Legislation?

By Claude P. Goddard (claude.goddard@akerman.com)

Section 852 of the National Defense Authorization Act of 2007 required the Department of Defense (DoD) to issue regulations to ensure that pass-through charges (indirect costs and profit) on contracts or subcontracts entered into by or on behalf of DoD are not excessive in relation to the cost of work performed by the contractor or subcontractor. The DoD first issued interim regulations on this topic in April 2007—set out at DFARS 215.408, 252.215-7003 (Excessive Pass-Through Charges—Identification of Subcontract Effort) and 252.215-7004 (Excessive Pass-Through Charges)—and sought public comments on them. On May 13, 2008, DoD published its summary of the public comments and its responses to them, and it issued revised interim rules on excessive pass-through charges. The revised interim regulations are very similar to those implemented in April 2007. The revised regulations simply add definitions of some terms ("added value," "subcontract," and "subcontractor"); change some terminology (from "value added" to "added value"); and expand reporting requirements—without changing the underlying principles incorporated in the clauses. They also adopted the cost or pricing data dollar-value threshold as the threshold for including the DFARS clauses and provided for an alternate provision allowing the contracting officer to determine in advance of award that no excessive pass-through charges are included in the

contract. The DoD has asked for comments on these newly revised interim rules by July 14, 2008.

It is clear from the volume and tenor of the comments that these rules are controversial and unpopular, but the DoD gave little relief to contractors. Its revised interim rules are as draconian as the earlier version. We'll discuss below the issues we see with these interim regulations, but first we'll describe what the regulations provide.

The revised interim regulation prescribes two contract clauses—DFARS 252.215-7003 and 252.215-7004—that must be included in contracts (including task and delivery orders) exceeding the threshold for obtaining cost or pricing data (currently \$650,000). Contracting Officers may include these clauses in smaller contracts if he or she deems their inclusion appropriate. The interim regulations exempt only two types of fixed priced contracts—firm fixed price contracts and fixed price contracts with economic price adjustment—from this prescription and only when such contracts are (i) awarded on the basis of adequate price competition or (ii) for the acquisition of a commercial item. Moreover, prime contractors must insert the substance of these clauses in all subcontracts except for the same types of fixed priced subcontracts (firm fixed priced subcontracts and fixed price subcontracts with economic price adjustment): (i) awarded on the basis of adequate price competition or (ii) for a commercial item. There is no cost or pricing threshold applicable to the flowdown of these clauses to subcontractors.

These clauses require offerors to exclude "excessive pass-through charges" from their proposals and prohibit the Government from paying such charges. An "excessive pass-through charge" is defined as "a charge to the Government by the Contractor or subcontractor that is for indirect costs or profit on work performed by a subcontractor (other than charges for the costs of managing the work performed and applicable indirect costs and profit based on such costs)" when a Contractor or subcontractor adds no or negligible value to a contract or subcontract. A contractor/subcontractor adds no or negligible value when it cannot demonstrate that its effort "added value" to the contract or subcontract in accomplishing the work performed under the contract. "Added value" is defined as meaning that "the Contractor performs subcontract management functions that the Contracting Officer determines are a benefit to the Government (e.g., processing orders of parts or services, maintaining inventory, reducing delivery lead times, managing multiple sources for contract requirements, coordinating deliveries, performing quality assurance functions)."

Under the revised interim regulations, the Government is entitled to (i) reduce the price by the amount of excessive pass-throughs included in the price of fixed price contracts or (ii) disallow the excessive pass-through charges as unallowable costs in other than fixed-price contracts. The Government is also granted the right to audit contracts and subcontracts as necessary to determine whether the contractor or subcontractor proposed, billed or claimed excessive pass-through charges.

The revised interim regulations further place the burden on contractors and subcontractors to disclose certain information. DFARS 252.215-7003 requires offerors to identify in their proposals:

- the total cost of the work to be performed by the offeror; and
- the total cost of the work to be performed by each subcontractor under the contract or task or delivery order.

If the offeror intends to subcontract more than 70 percent of the total cost of work, the offeror must identify in its proposal (or do so in a written notice to the Contracting Officer if, after award, the contractor changes the amount of work subcontracted to exceed 70 percent):

- the amount of indirect costs and profit applicable to the work to be performed by the subcontractors; and
- a description of the "added value" provided the offeror as related to the work to be performed by the subcontractors.

Offerors must also disclose in their proposal (or do so in a written notice in the event of a change after award) the amount of indirect costs and profit and a description of the added value by a subcontractor if the subcontractor intends to subcontract more than 70 percent of the total cost of work to be performed under its subcontract. The contracting officer can make a determination in advance that there will be no excessive pass-through charges, provided the contractor or subcontractor performs the disclosed value-added functions.

There are many potential issues raised by these interim regulations. Some of the issues we see are as follows:

- They place additional risk on contractors who award subcontracts non-competitively—their firm fixed prices will no longer be firm nor fixed;
- They allow the Government an additional avenue of price reductions/disallowances even where the contractor and/or subcontractor has fully disclosed its cost or pricing data pursuant to the Truth in Negotiations Act (TINA);
- They will place an undue burden on contractors who serve as project managers of construction projects, as such contractors commonly subcontract out more than 70 percent of the cost of work;
- They will make "make or buy" decisions unnecessarily complex—contractors likely will favor a "make" decision, regardless of whether it's a better value for the Government, so they don't risk a later price reduction or disallowance;
- They create uncertainty over whether contractors/subcontractors can add any pass-through charges when buying from distributors or product vendors, or whether pass-through charges added by distributors or vendors will be considered excessive;
- They require that, when the clauses are included in the prime contract, the clauses must be flowed down to all subcontracts (except the two types of exempted fixed price subcontracts) regardless of whether the subcontracts are in excess of the TINA threshold; and

- They will make it more difficult for contractors to meet their small business subcontracting goals.

Other commentators on the April 2007 interim regulations have outlined other concerns flowing from these requirements. Those comments can be found at <http://www.regulations.gov> and are summarized by the DoD at 73 Federal Register 27,464 (May 13, 2008).

Update: False Claims Act Case Based on Undisclosed OCI Going to Trial

By Daniel J. Donohue (daniel.donohue@akerman.com)

Our September 2007 Roundup reported a decision of the U.S. District Court for the District of Columbia that raised interesting issues about whether a contractor's activities in a trade advocacy group could create an undisclosed Organizational Conflict of Interest (OCI) and for that OCI to create the basis for civil False Claims Act liability. In United States v. SAIC, the court denied a contractor's Motion to Dismiss and allowed the False Claims Act case to proceed. The Government alleged that the contractor's undisclosed support of a trade advocacy group created an OCI and that, because the OCI was not revealed to the Government, the contractor obtained the contract by fraud.

The case involves an unusual contract with an unusual OCI clause and the Court assumed the truth of all the allegations in the Complaint in denying the contractor's Motion to Dismiss. The case was newsworthy because it alleged that the contractor's activities with a trade group could create an OCI, and that knowing concealment of an OCI could lead to False Claims Act civil liability for treble damages and penalties. Our article expressed concerns that this unusual case might expand use of the False Claims Act to address breaches of contract and expressed hope that the court might clarify its decision as the case proceeds.

On May 15, 2008, the same court issued another decision granting in part and denying in part the contractor's Motion for Summary Judgment. This most recent decision does not retreat one bit from the earlier decision. The new decision allows the Government to proceed to trial on the False Claims Act allegations arising from the alleged OCI due to the contractor's involvement with the trade advocacy group.

The new decision held that the Government's Amended Complaint pleaded the allegedly false claim with the requisite specificity as required by the heightened pleading requirements applicable to allegations of fraud. It also held that the alleged fraudulent intent of the contractor may be proven through the "collective intent" of its employees. The decision also granted the contractor's motion for summary judgment as to alleged OCI's not specifically alleged in the Complaint, struck claims for damages the government failed to support and dismissed a quasi-contract count because the parties agree there was an express contract.

Background and the Prior Decision

The case involves Nuclear Regulatory Commission (NRC) contracts awarded in 1992 and 1999 for a contractor to provide technical assistance and advice to NRC about whether NRC should allow low-level radioactive materials to be released to the private sector for recycling. The NRC regulates civil use of such nuclear material and creates scientific standards for release of materials with low-levels of contamination. According to the Government, the whole idea of the contract was to engage a contractor to provide impartial advice on this policy issue, and to have a contractor that would be viewed as independent and impartial by the industry the NRC regulates. The Government's position was that the contract required the contractor to be neutral regarding the recycling issue and that the OCI provisions required this neutrality.

Decision Denying Summary Judgment on the False Claims Act – Implied Certification Theory

The Amended Complaint alleged that the contractor's undisclosed OCI's included undisclosed contracts with private companies to develop technology and assess safe radioactive emission levels and support by the contractor and one of its Vice Presidents of a trade association that advocated for recycling radioactive materials. The Government's theory was that by withholding information about these alleged OCI's the contractor fraudulently caused Government personnel to approve payments that would not have been made had the contractor disclosed these OCI's. The court described this as a false "implied certification" that no OCI's existed.

The contractor argued that a false implied certification can support a False Claims Act claim only when it relates to an express condition precedent required to obtain payment. The court rejected the argument, citing a Declaration by the Contracting Officer that he would not have approved the payments had the contractor disclosed the relationships forming the alleged OCI.

Relationships with the Trade Advocacy Group - ARMR

In the earlier decision, the court denied the contractor's motion to dismiss the claims based on the alleged relationships between the contractor and the trade association, the Association of Radioactive Metal Recyclers (ARMR). The contractor had argued as a matter of law that a non-contractual relationship with a trade association cannot violate the contract's OCI clause because the clause prohibited only "consulting or other contractual arrangements." But the earlier decision rejected that argument, holding that the contract incorporated an NRC regulation that also forbade a non-contractual "relationship" with an organization advocating a position regarding the contract work. Although the NRC had since repealed that regulation, the court held that the parties validly agreed to it in the contract.

The contractor then moved for summary judgment, asserting that the undisputed facts showed that the contractor itself (as a company) had no relationship with the trade association and had refused several invitations to join, but that its Vice President's

involvement as a member of the trade group was purely personal. But the new decision denied the contractor's motion.

The court cited language in the contractor's proposal that could be construed as saying that the Vice President's involvement with the trade group had ended. The court said that a trier of fact could conclude that the contractor's proposal intentionally misrepresented the Vice President's current involvement with the trade group. The court found that there were disputed facts about whether the contractor itself misrepresented the OCI's and denied summary judgment.

Collective Knowledge of Employees May Prove Company's Intent to Deceive

Perhaps the most interesting portion of the court's recent decision has to do with allowing the Government to rely upon the collective actions and knowledge of the contractor's employees as the basis to prove that the contractor itself knowingly and willfully submitted false statements in the contractor's proposal.

The contractor asserted that no document or witness provided evidence that the company was aware of an OCI and intentionally submitted false statements in the proposal to misrepresent the existence of OCI's. The court rejected this argument stating that "it is both appropriate and equitable to conclude that a company's fraudulent intent may be inferred from all of the circumstantial evidence including the company's collective knowledge." That is, the collective knowledge of the employees.

Even if the "collective knowledge" theory were wrong, however, the court said that it still would find sufficient disputes of material fact to deny summary judgment as to the intent of the contractor. The court held that the knowledge of even one employee could prove knowledge of the company, stating, "the issue of material importance . . . [is] whether there was at least one . . . employee who knew or should have known that [the defendant] was submitting a bid seeking government funds and that this bid was tainted by an OCI." The court found that the government presented sufficient evidence that might allow a trier of fact to conclude that the Vice President, who was involved with the trade group, was aware that the contractor submitted its proposal without identifying OCI's when in fact he knew OCI's existed.

The court scheduled a trial beginning July 1, 2008. So the next development may be a verdict. Whatever the merits of this individual case, we continue to have concerns that this unusual case may lead to an expansion of civil False Claims Act claims to areas of pure breach of contract.

Court Finds "Revolving Door" Exclusion Was Improper

By Steven J. Koprince (steven.koprince@akerman.com)

Under a recent decision by the United States Court of Federal Claims, a contractor may not be excluded from a solicitation on the basis that the contractor's employee previously performed a small amount of related work for the Government. The court's decision in CNA Corp. v. United States, No. 08-249C (Fed. Cl. Apr. 30, 2008) is welcome news for contractors, especially those whose workforce includes a number of former government employees. However, although the outcome of this case was favorable, CNA Corp. also serves as a reminder to contractors that in some cases, an employee's previous Government work can cause conflict of interest problems.

The CNA Corp. decision arose out of a solicitation by the Department of Health and Human Services ("HHS") for a long-term study to assess the effect of environmental exposures on children's health and development. The study was to take place at 105 study locations nationwide, and HHS was to award a separate contract for each study location. CNA Corporation ("CNA") entered a bid for a contract at the Montgomery County, Maryland facility. After CNA had made its bid, HHS issued an ethics finding excluding CNA from the competition. The ethics finding was based on the prior employment of one of CNA's employees, whom CNA proposed to use in a major role on the contract. Before joining CNA, this employee had worked for more than fifteen years for a division of HHS. According to the Government, this prior employment presented a conflict of interest.

CNA filed a bid protest, arguing that its exclusion was improper. It argued that the employee's work for HHS was almost entirely unrelated to the children's health contracts at issue in the solicitation. The court agreed with CNA and sustained its bid protest.

The court's ruling was based on the regulations restricting former employees from attempting to influence the Government. Under 18 USC § 207(a)(1), a former Government employee cannot attempt to influence the Government in a matter in which the Government has a substantial interest and in which the former Government employee "participated personally and substantially" during his or her employment with the Government. Here, the Court found that some 2,500 Government personnel, including more than 200 scientists, provided input in creating the studies. Although CNA's employee was one of the 2500 employees who participated, her work on the study was part-time, and her team's work was limited to "draft" recommendations, not dispositive decisions. Given the massive nature of the project and the relatively minor work of CNA's employee on the project, the court found that she was not "personally and substantially" involved in the project under the statute.

The CNA Corp. decision is favorable for contractors who often hire former Government employees due to the invaluable experience and expertise those persons can provide. Nevertheless, CNA Corp. should also remind contractors that they must be fully aware of the nature and scope of their employees' former Government work and take care

to avoid proposing those employees for projects in which the employees were "personally and substantially" involved during their Government tenure.

Fraud Prevention Corner – FAR Councils Add Civil False Claims Violations to Proposed Reporting Rule

By J. Michael Littlejohn (michael.littlejohn@akerman.com)

In response to pressure from the Hill to close the "loopholes" in the recently proposed rule to require contractors to report fraud, the FAR Councils issued a revised proposed rule for comment on May 16, 2008 (73 FR 28407) (FAR Case 2007-006). In the revised proposed rule, the FAR Councils added three provisions to address issues raised by "commenters." First, to address Congressional questions that the rule provided a "loophole" for contractors in Iraq (such as KBR and others), the Councils proposed to include the reporting requirement in contracts to be performed outside the United States. Second, they decided that the reporting rule should apply to commercial item contracts. Finally, in response to a request from DOJ, the Councils added the requirement for contractors to report suspected violations of the Civil False Claims Act in addition to the duty to report an overpayment or a violation of criminal law. This last change is a considerable expansion of the rule that already caused concern in requiring contractors to disclose suspected violations or violations of criminal statutes. Now, the FAR Councils would propose to require contractors to disclose potential civil false claims at the risk of being debarred for failure to do so. In the past, contractors might have disclosed such violations voluntarily to avoid severe penalties and to maintain a trusted relationship with their government customer. Now one of the many questions raised by this new proposed rule is whether a contractor will avoid sanctions or receive any leniency in penalties, fines, or debarment proceedings for coming forward with such issues. Needless to say, the newly proposed rule raises concerns for industry and portends a significant change in the relationship between contractors and their government customers. Comments on the revised rule are due July 15, 2008.

Upcoming Events

Lawyers Have Heart 10-K and Fun Walk

June 14, 2008

Washington, D.C.

Akerman Senterfitt's Tysons Corner and Washington, D.C. offices will be fielding a team for the Lawyers Have Heart 10-K and Fun Walk on Saturday, June 14, 2008. Over the past ten years, Lawyers Have Heart has raised more than \$4.3 million to benefit the American Heart Association, and Akerman Senterfitt is proud to be doing its part to help! If you would like to make a donation, or to find out how to join us on June 14, contact sarah.graves@akerman.com.

PWC-CRC Presents: "Killer Contract Clauses"

July 10, 2008

Akerman Senterfitt Wickwire Gavin

Vienna, VA

The Capital Region Chapter of Professional Women in Construction will host an exciting and educational panel discussion addressing problematic contract clauses and the contracting process from the perspective of owners, design professionals, and contractors. The panelists will be: Susan Boggs (Turner Construction Corporation), Bob Carney (Whiteford, Taylor & Preston), *Don Gavin (Akerman Senterfitt Wickwire Gavin)*, and Tamara McNulty (Duane Morris). For more information, contact sarah.graves@akerman.com.

About Our Government Contracts Group

The Government Contracts Group at Akerman Senterfitt Wickwire Gavin assists large and small businesses with all types of federal government contracts issues. To do business with the federal government, contractors must deal with a unique and complicated series of statutes, regulations and procedures. We help clients work with this system to maximize contracting opportunities with federal government agencies. We provide counseling and representation to clients in the areas of contract compliance issues, bid protests, Small and Disadvantaged Business matters, contractor and subcontractor claims administration, construction contracts, information technology contracts, and international contracts. In addition, we are uniquely qualified to advise and assist contractors who provide goods or services to the U.S. Postal Service.

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